Supreme Court, U.S.
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90-1450

No.

IN THE

Supreme Court of the United States

OCTOBER TERM. 1990

GLK, INC.,
Petitioner,
vs.
UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Does the Court's opinion in *United States v. Energy Resources Co., Inc., et al.*, 110 S.Ct. 2139 (1990), preclude a tax allocation provision in a bankruptcy reorganization plan where the provision is not "necessary to the success of the reorganization plan," notwithstanding statutory language and over 100 years of common law to the contrary?

If the answer to the preceding question is "no," is a debtor entitled to include a provision in its reorganization plan allocating payments to the IRS first to the trust fund portion of the debtor's tax liability?

PARTIES TO THE PROCEEDING

There are no parties to this proceeding other than appearing in the caption of the case. Although not a separate party, the Internal Revenue Service is the agency of the United States directly effected by this proceeding.

Petitioner GLK, Inc. has no parent or subsidiary corporation.

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In The
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UNITED STATES OF AMERICA

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

OPINION BELOW

The opinion of the court of appeals (App. A, *infra*, 1a-2a) is reported at 921 F.2d 967. The findings of the bankruptcy court on remand (App. B, *infra*, 3a-7a), the opinion of the bankruptcy appellate panel (App. C, *infra*, 8a-11a), and the original order of the bankruptcy court (App. D, *infra*, 12a-13a) are all unreported.

JURISDICTION

The judgment of the court of appeals (App. A, infra, 1a-2a) was entered on December 28, 1990. The

jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

Section 105 of the Bankruptcy Code, 11 U.S.C. § 105, provides in pertinent part:

Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. * * *

* * * * *

Section 1123 of the Bankruptcy Code, 11 U.S.C. § 1123, provides in pertinent part:

Contents of plan

* * * * *

(b) Subject to subsection (a) of this section, a plan may--

* * * * *

(5) include any other appropriate provision not inconsistent with the applicable provisions of this title.

STATEMENT

GLK, Inc. is a corporation in reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. § 1101 *et*

seq.). Its pre-petition debts included both "trust fund" and "non-trust fund" taxes. "Trust fund" taxes are those personal income and social security taxes withheld from employee's wages and required to be paid over to the Internal Revenue Service. *See*, *Slodov v. United States*, 436 U.S. 238, 242-243 (1978).

1. GLK filed for relief under Chapter 11 of the Bankruptcy Code (11 U.S.C.) on April 26, 1985. On July 22, 1987, GLK filed its proposed Plan of Reorganization (hereinafter referred to as the "Plan"). The Plan contained a provision that payments to the Internal Revenue Service would be "applied first to any trust fund liability..."

2. The United States (Internal Revenue Service)[1] objected to the allocation provision of the Plan on August 20, 1987. On September 16, 1987, GLK's Plan was confirmed, except for the provision which designated that payments made to the IRS would be applied first to "trust fund" liabilities. The issue of whether the Plan could contain such a provision was set for hearing.

3. On November 30, 1987, the Ninth Circuit Court of Appeals issued its decision in *In re Technical Knockout Graphics*, 833 F.2d 797 (9th Cir. 1987). In *Technical Knockout Graphics*, the Ninth Circuit accepted as if law, an IRS policy permitting debtors to designate how tax payments are to be applied if such payments are "voluntary," but denying that right, and allocating payments as the IRS wishes, if payments are "involuntary." The Ninth Circuit acknowledged that "Federal courts have struggled with the voluntary/involuntary distinction in the bank-

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[1] The United States (Internal Revenue Service) is hereinafter sometimes referred to as the "IRS."

ruptcy context and have come to different conclusions." *Technical Knockout Graphics*, 833 F.2d at 802. The Ninth Circuit there held, however, that "payments made by a debtor in possession after filing a petition for reorganization under chapter 11, but prior to confirmation of a reorganization plan, are involuntary and the bankruptcy court does not have equitable jurisdiction to order otherwise." *Id.*

4. Hearing on the designation in GLK's Plan was held on December 22, 1987. GLK argued, *inter alia* that the "voluntary-involuntary dichotomy" was an inappropriate and erroneous rule of law. That issue still has not been addressed in any reported case. The Bankruptcy Court nevertheless felt compelled to find GLK's tax payments "involuntary" and to strike the allocation provision, following *Technical Knockout Graphics*. The Bankruptcy Court's Order Re Payments by Debtor to Internal Revenue Service Under Plan of Reorganization (App. D) was entered February 23, 1988.

5. The order was appealed to the Bankruptcy Appellate Panel ("BAP"), which affirmed the Bankruptcy Court, having extended the Ninth Circuit's "voluntary-involuntary" reasoning in *Technical Knockout Graphics* to payments made pursuant to a reorganization plan in *United States v. Condel, Inc. (In re Condel)*, 91 B.R. 79 (9th Cir. BAP 1988). The BAP similarly refused to consider GLK's arguments that the "voluntary-involuntary dichotomy" was an erroneous rule of law. GLK's Motion for Rehearing was denied on March 1, 1989.

6. The Memorandum Decision of the Bankruptcy Appellate Panel was appealed to the Ninth Circuit Court of Appeals on March 8, 1989.

7. On March 31, 1989, the First Circuit Court of Appeals decided *In re Energy Resources Co., Inc.*, 871 F.2d 223 (1st Cir. 1989). There the IRS similarly argued that it was entitled to allocate tax payments of a debtor in reorganization any way it chose because it characterized such payments as "involuntary." *Id.* at 225-226. The First Circuit concluded that bankruptcy courts possess the legal power to order the IRS how to apply payments, even if such allocation conflicts with the IRS's internal policies as to allocations. *Id.* at 230.

8. On November 13, 1989, this Court granted certiorari in *United States v. Energy Resources Co., Inc.* "because the First Circuit's conclusion on this issue conflicts with decisions in other circuits. 493 U.S. ___; *see, e.g., In re Ribs-R-Us, Inc.*, 828 F.2d 199 (CA3 1987)." *United States v. Energy Resources Co., Inc.*, 110 S.Ct. 2139, 2141 (1990). GLK submitted a brief to this Court as *amicus curiae* because it was in a position identical to that of Newport Offshore, Ltd., one of the respondent's in *Energy Resources*, and that of Ribs-R-Us, Inc. in *Ribs-R-Us*. On May 29, 1990, this Court decided *United States v. Energy Resources Co., Inc.*, 110 S.Ct. 2139 (1990), (hereinafter referred to as "*Energy Resources*"). This Court stated that "the bankruptcy court has the authority to order the IRS to apply the payments to trust fund liabilities if the bankruptcy court determines that this designation is necessary to the success of a reorganization plan." *Id.* at 2142.

9. Citing this Court's *Energy Resources* Opinion, the Ninth Circuit ordered this case remanded for the bankruptcy court "to make specific findings on the question whether it is *necessary* to the success of the Plan or [sic, of] Reorganization of the debtor, GLK, Inc., that tax payments to the Internal Revenue Service under the Plan be allocated first to the payment of the 'trust fund'

portion of taxes owed." [emphasis added] Order dated June 29, 1990.

10. On remand, the bankruptcy court found that an allocation was not *necessary* to the success of the Plan since (i) the Plan was apparently working, and (ii) the IRS stipulated not to pursue enforced collection of the liability from GLK's responsible officers under section 6672 of the Internal Revenue Code (26 U.S.C.), thereby eliminating any concern about distracting the efforts of GLK's officers from the reorganization. The Ninth Circuit, relying on this Court's opinion in *Energy Resources*, thereupon affirmed the bankruptcy court order striking GLK's allocation provision, saying that:

> "[because the bankruptcy court found that GLK's allocation provision was not necessary to the success of the plan of reorganization,] regardless of whether the payments are classified as "voluntary" or "involuntary" the bankruptcy court did not err in striking the allocation language from the plan."

By so holding, the Ninth Circuit interpreted this Court's Opinion in *Energy Resources* as creating a new "dichotomy," *i.e.*, that a debtor reorganizing under Chapter 11 of the Bankruptcy Code may include a provision allocating tax payments to the IRS if such a provision is "necessary" to the success of the reorganization plan, but may not do so if such provision is not found "necessary."

REASONS FOR GRANTING THE PETITION

The Ninth Circuit Court of Appeals Opinion raises an important question of Federal law by interpreting this Court's *Energy Resources* Opinion in a way which:

(a) reaches a result opposite that reached in *Energy Resources* on indistinguishable facts, thereby

conflicting with the holding of this Court and the First Circuit;

(b) deprives GLK of a common law right recognized by this Court for more than 100 years; and

(c) is directly in conflict with unambiguous provisions of the Bankruptcy Code.

Because the Ninth Circuit decision relies solely on this Court's Opinion in *Energy Resources*, the conflicts and questions presented by the Ninth Circuit's decision can only be resolved by this Court.

1. Petitioner GLK is in the same position as Newport Offshore, Ltd., was in *Energy Resources*. Both GLK and Newport Offshore, Ltd., were corporations which filed petitions under Chapter 11 of the Bankruptcy Code. Both filed reorganization plans which included a provision that payments to the IRS were to be allocated first to the "trust fund" portion of the debtors' respective tax obligations. In the case of Newport Offshore, Ltd., the bankruptcy court initially allowed the provision; the district court reversed, however, following the Third Circuit Court of Appeals in *In the Matter of Ribs-R-Us, Inc.*, 828 F.2d 199 (3rd Cir. 1987). *Ribs-R-Us* held that tax payments made pursuant to a Chapter 11 reorganization plan were *per se* "involuntary." In petitioner GLK's case, the bankruptcy court felt compelled to follow the Ninth Circuit Court of Appeals decision in *In re Technical Knockout Graphics, Inc.*, which held that a pre-plan payment by a bankrupt debtor was also a *per se* involuntary payment which the debtor was precluded from allocating.

Although both debtors in *Energy Resources* were permitted by the First Circuit and this Court to designate the allocation of payments first to trust fund taxes, that same right was denied GLK by the Ninth Circuit. The resolution of the conflict sought in *Energy Resources* has clearly not been accomplished. The Ninth Circuit did not

purport to address a question left unanswered by *Energy Resources*. It curiously suggested, by effect, that *Energy Resources* itself required the denial of GLK's allocation right.

The Ninth Circuit erroneously saw its holding in this case as consistent with *Energy Resources* by interpreting *Energy Resources* as requiring a finding that an allocation provision is "necessary" before it is permissible. No such finding existed in *Energy Resources*, however. In *In re Energy Resources Co.*, 871 F.2d. 223 (1st Cir. 1989), the First Circuit was satisfied only that the allocation made by Newport Offshore, Ltd. in its plan was "both fair and [would] help to rehabilitate the company." *Id.* at 234. In the case of Energy Resources, Inc., the First Circuit noted only that the bankruptcy court "heard argument about the trustee's claim that the designation would not significantly hurt the IRS, and that it was 'necessary' for the trustee to maximize the extent to which the IRS payments would 'benefit the estate.'" *Id.* at 234. The record is devoid of any specific finding that the designation in the case of either Energy Resources, Inc., or Newport Offshore, Ltd., was "necessary" to the success of either debtor's reorganization plan.[2]

Since, in *Energy Resources*, this Court allowed a reorganization plan provision applying tax payments first to trust fund tax liabilities without any actual finding of "necessity" by the lower courts, the requirement of necessity for a virtually identical provision in GLK's Plan, presented under virtually identical facts, conflicts with the decisions of both the First Circuit and this Court. The conflict should be resolved by this Court.

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[2] Petitioner believes that the use of the term "necessary" by this Court was an indirect reference to section 105 of the Bankruptcy Code (11 U.S.C.), which grants bankruptcy courts authority to issue "necessary" orders. *See, infra* section 4.

2. In deciding that a debtor may not designate how payments made pursuant to a reorganization plan will be applied unless the designation is "necessary" to the success of the plan, the Ninth Circuit deprived GLK of a right long recognized by this Court, and has clouded the application of longstanding common law principles. The Ninth Circuit relied on this Court's *Energy Resources* opinion to avoid addressing petitioner GLK's arguments on that point.

a. The general rule of law in this Country regarding application of payments is well settled that:

> "... the debtor or party paying the money may, if he chooses to do so, direct its appropriation; if he fail, the right devolves upon the creditor; if he fail, the law will make the application according to its own notions of justice. Neither of the parties can make it after a controversy upon the subject has arisen between them, and *a fortiori* not at the trial."

National Bank of the Commonwealth v. Mechanics' National Bank, 94 U.S. 437, 439 (1876), citing *United States v. Kirkpatrick*, 22 U.S. (9 Wheat.) 720 (1824), *United States v. January*, 11 U.S. (7 Cranch) 572 (1813), and *Field v. Holland*, 10 U.S. (6 Cranch) 8 (1810). *See also*, *First Nat. Bank in Palm Beach v. United States*, 591 F.2d 1143, 1147 (5th Cir. 1979), citing, among other authorities, *Tayloe v. Sandiford*, 20 U.S. (7 Wheat.) 7, 9-10 (1822). The applicability or logic of the general rule has not been questioned in any relevant decision.

The logic and justice of the traditional rule is rooted in the simple right to control one's own property. *See, e.g., Bank of California v. Webb*, 94 N.Y. 467, 472 (1884), where the court stated:

> "A debtor paying money to a creditor to whom he owes several debts may direct the application of the payment because the money is his and he may

> do as he will with it and control its application. But the debtor must exercise his option as to the application when he makes the payment. After that the money has ceased to be his and is no longer subject to his control. Then it belongs to the creditor, and he is master of it, and may control its application..."

See, also, 40 AM. JUR. *Payment* §110 at p. 792. The rule's roots in the concept of control continue to be recognized in recent cases. *See, e.g., Federal Land Bank v. Wilson*, 719 F.2d 1367, 1371 (8th Cir. 1983), ("A debtor desiring to avail himself of his right to direct the application of a payment must give the direction therefor either before or at the time of payment; otherwise, the right is lost, because thereafter the money ceases to be his, and is no longer subject to his control.").

The common law wisdom suggests the appropriate rule: chapter 11 debtors should be permitted, as other debtors, to designate the allocation of payments made absent a finding by the bankruptcy court that the debtor-proposed allocation offends some provision of the Bankruptcy Code. Upon such a finding, the bankruptcy court is authorized by section 105 to enter an appropriate order.

Notwithstanding the historical recognition of a debtor's right to designate application of payments, GLK has been flatly denied its common law right because the Ninth Circuit erroneously interprets this Court's Opinion in *Energy Resources* as requiring a finding of "necessity" *before* a debtor may exercise that right.

b. IRS policy permits taxpayers to designate how "voluntary" tax payments will be applied; however,

"involuntary" payments are applied as the IRS wishes.[3] By denying GLK the ability to include an allocation provision in its Plan, the Ninth Circuit has effectively granted the IRS administrative authority to deny debtor rights. No such power is granted by statute.

The IRS has claimed that its allocation policy reflects the common law policy. *In re Energy Resources Co., Inc.*, 871 F.2d at 227. That claim is not true.

The use of terms regarding volition in court decisions neither reflects nor supports application of the voluntary-involuntary dichotomy used by the IRS and applied without question in recent decisions. Under early authorities, the creditor's right to designate how payments would be applied upon the debtor's failure to do so was as dependent on so-called "voluntary" payments as was the debtor's right. *See, e.g.*, 40 AM. JUR. *Payment* §109 at p. 791 and §111 at p. 793, citing *Orleans County Nat. Bank v. Moore*, 112 N.Y. 543, 20 N.E. 357 (1889) for the proposition that "[t]he right of a debtor to make an application of a payment, or, in the event of his failure to do so, the right of a creditor to make such an application, may be exercised only in cases of voluntary payment." Thus, the labelling question, considered so important in IRS policy and recent disputes, contributes nothing to the analysis suggested by traditional wisdom.

Later works describing the common law also fail to support the IRS's claim saying, *e.g.*, "In [cases involving involuntary payments, such as resulting from execution or judicial sales,] neither the debtor nor the creditor has a right to make an application..." 70 C.J.S. *Payment* §37 at p. 33, citing *Safe Deposit & Trust Co. v. Woodbridge*, 184 Md. 560, 42 A.2d 231 (1945), which itself relied upon

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[3] That "rule" (that a debtor may designate how "voluntary" payments are to be applied, and that the I.R.S. is free to apply "involuntary" payments as it wishes) is referred to in this brief as the "voluntary-involuntary dichotomy," or sometimes as the "dichotomy."

Orleans County Nat. Bank v. Moore. *See also*, 60 AM. JUR.2D *Payment* §103, p. 948, which cites *Orleans County Nat. Bank v. Moore, First Nat. City Bank v. Kline*, 439 F.Supp. 726 (S.D.N.Y. 1977), and *Safe Deposit & Trust Co. v. Woodbridge*, both of the last two of which themselves rely on the first.

In *Orleans*, the debtor's lack of volition as to payments made pursuant to a judicial foreclosure sale precluded any creditor right to apply the payment as well as any debtor right. Use of the term "voluntary" in that case was not used as a criterion for debtor application, but to describe the presence of control. The essence of control as the true determinant is further underscored by the *Orleans* court's reference to a note on the cases of *Mayor et al. v. Patten*, 8 U.S. (4 Cranch) 317 (1807), and *Field v. Holland*, 10 U.S. (6 Cranch) 8 (1810), expressing that:

> "... the general principle of the common law is that the ownership of money determines the right of appropriation; and after it is paid, the debtor can make none." *Orleans County Nat. Bank v. Moore*, 20 N.E. at 364.

The Court went on to say:

> "It would seem that in cases of payment *in invitum*, or by judicial proceedings, the creditor does not become the owner of the money until it is paid, and the law at the very time of the payment makes its own application, and the creditor has no opportunity to make it himself."

Id. The above statement has been accepted as a proper description of the common law. *See*, 40 AM.JUR. *Payment*. §139 at p. 811 (citing *Orleans County Nat. Bank v. Moore*). The logic of *Orleans* is clear and consistent: the property there involved (and the concomitant right of control over it) was divested from the debtor in the foreclosure action and subjected to the jurisdiction (and therefore control) of the court. The issue decided was

how the court would exercise its control in allocating the payment among three debts owed by the debtor. After reviewing both English and American authorities, the court exercised its discretion and applied the monies *pro rata* among all three debts.

Since no statute preempts the common law regarding application of payments or authorizes the IRS to promulgate regulations which would curtail a tax debtor's otherwise existing rights, when the issue of application of payments was presented to the courts in the context of taxation, the courts naturally and properly looked to the same common law rules. Unfortunately, the failure of three seminal decisions to adequately articulate those rules set the stage for the confusion and conflicts which are now presented for resolution by this Court.

In *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964), the Tenth Circuit Court of Appeals held that although the bankruptcy court had properly exercised jurisdiction over funds deposited with it but not belonging to the bankruptcy estate, the bankruptcy court lacked jurisdiction to direct application of the funds in any particular manner. The Tenth Circuit there said:

> "As a general rule, a debtor voluntarily paying his debt may direct application of his money to such items or demands as he chooses. 70 C.J.S., Payment, § 52, pp. 257-259; 40 Am.Jur., Payment, § 110, pp. 792-793. But, such is not the case where, as here, the payment is made involuntarily as in an execution or judicial sale. 70 C.J.S., Payment, § 51, pp. 256-257; 40 Am.Jur., Payment, § 139, pp. 811-812."

Id. at 456. The Court quoted only *part* of the common law rule and therefore wrongly expressed and interpreted it. As previously discussed, C.J.S. and AM. JUR. both relied upon *Orleans Nat. Bank v. Moore* for the proposition cited and all three authorities clearly express that, in the case of "involuntary" payments, it is *neither* the

debtor *nor the creditor*, but indeed *is* the court, to properly determine application of the payments made under its order. Having determined that the exercise of the bankruptcy court's jurisdiction over the monies was proper, the very authorities cited by the Court suggest that the Court was under a duty to apply the monies in accordance with equitable principles.[4]

A few years later, the Tax Court, in *Amos v. Commissioner*, 47 T.C. 65 (1966), held that amounts received by the IRS pursuant to administrative levies could be applied between assessments of tax, penalties and interest as the IRS chose. The Tax Court acknowledged the general rule as well as the historical limitations to its application, saying, with respect to the latter:

> "In many jurisdictions, including Illinois where these payments were made, it is held that the rule giving the debtor or creditor the right to direct the application of *voluntary* payments has no application to *involuntary* payments." *Id.* at 68 [emphasis by court].

In a footnote, the court recognized a critical distinction between the "involuntary" exception to the general rule and the case of an administrative levy then before it, saying:

> "Usually cases applying [the rule denying the debtor and *creditor* the right to direct the application of involuntary payments] involve judicial proceedings, such as bankruptcy, receivership, probate, or mortgage and lien foreclosures, in which the sale of property is under the umbrella of the court's supervision. In such situations the

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[4] The result reached could have been justified as the Court's refusal to make an allocation in the exercise of its discretion, *i.e.*, to intentionally allow the payment to be made unallocated. Such was not the reasoning of the Court, however.

> court, in its discretion, determines the application of payments according to legal and equitable principles. There is no court supervision or control over payments received by a district director as a result of administrative collection of Federal taxes by levy or distraint." *Id.* at 68 & n. 3. [emphasis added].

The *Amos* Court did recognize the significance of control and acknowledged court-directed application of court-controlled funds.

Applying the historical common law approach and analysis of control, the court's decision was appropriate and consistent with traditional reasoning. From the time of the levy, the taxpayer/debtor lost control of, and therefore the right to designate the application of proceeds from, the property seized or levied upon. There being no court involvement or other intermediary exercising legitimate control over the property or funds, the right of control and concomitant right to direct application devolved upon the IRS.

The *Amos* Court's discussion was not without some confusion, however. It appears that the confusion stemmed at least in part from the *O'Dell* decision, which the court recognized as an aberration. The *Amos* Court mentioned a "minority view" that "some jurisdictions give the creditor the right to direct the application of involuntary as well as voluntary payments." *Amos* at 69. Recognizing (but not so stating) that the *O'Dell* recitation of the general rule was incorrect, the Court suggested that the *O'Dell* court had "adopted" the minority view with respect to taxes. Clearly, however, that was not the case. To that time, *no* rule, including the "minority view," gave debtors discretion in the application of "voluntary" payments and creditors unfettered discretion in the application of "involuntary" payments. As previously discussed, the *O'Dell* discussion was a misguided or

incomplete attempt to apply the traditional "majority" rule.

The third seminal case exploring application of the allocation rules in the context of tax cases was *Muntwyler v. United States*, 703 F.2d 1031 (7th Cir. 1983). In *Muntwyler*, the IRS filed a claim for trust fund and non-trust fund taxes with a non-judicial trustee/assignee for the benefit of the taxpayer/debtor's creditors. The trustee made payments to the IRS directing their application to trust fund taxes. The IRS accepted the money, but refused to honor the direction regarding application of it. The district court upheld the allocation, finding the *trustee/assignee's* payment "voluntary." The Seventh Circuit also applied the "voluntary-involuntary dichotomy," and again to the *trustee/assignee's* payment, stating:

> "The sole question, therefore, is whether the district court correctly held that the assignee's payment was voluntary." *Id.* at 1033.

The IRS argued that the payment was involuntary (presumably as to the *debtor*) because it was made pursuant to an IRS administrative claim filed with a third party assignee, relying on language in *Amos*. The court disagreed, however, saying:

> "The distinction between a voluntary and involuntary payment in *Amos* and all other cases is... the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy." *Id.* at 1033. [emphasis by the court].

The significance of the "seizure" language appears to be the clear transfer of control over the seized property away from the payor resulting from such action.

It is significant that while all prior cases applying the "voluntary-involuntary dichotomy" examined the *taxpayer's* volition, here the court focused on and was persuaded by IRS action or inaction, *i.e.*, by the absence

of a *seizure* by the IRS, noting that the only action of the IRS was to file a claim.

Common law analysis takes a different path to the same result and also suggests the analytical deficiencies which have, over the years, produced so much litigation over the same or similar issues arising in the Chapter 11 bankruptcy context. Upon its assignment to the trustee, the *Muntwyler* debtor lost control over his property and with it the right to designate how the trustee's payments would be applied. Control, however, vested in the trustee, not the IRS. The trustee/assignee, therefore, having title to and control over the property (albeit subject to his duties as assignee for the benefit of creditors), had the legal right and power to direct application of payments made. It was necessarily the latter fact of assignee control, rather than the former fact of the debtor's loss of control, that the court focused on (in saying that the *assignee's* payment was voluntary) and which lead to the result. By understanding, acknowledging and applying the traditional rules, the same appropriate result could have been reached without the laborious inquiry concerning volition. Although couched in terms of volition, the issue has always been one of the simple property right of "control."

The IRS policy neither reflects the common law rule nor is generally recognized outside the taxation context; however, courts have continued to apply the dichotomy as law, without questioning its validity or the propriety of its application. *See, e.g., In re DuCharmes & Company*, 852 F.2d 194, 196 (6th Cir. 1988), ("...payments made to the I.R.S. on pre-petition tax liabilities by a Chapter 11 debtor ought to be considered 'involuntary payments' that may not be allocated [by the debtor]..."), *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 201 (3d Cir. 1987), ("Ribs-R-Us does not challenge the proposition that its entitlement to designate payments depends on whether we view the payments as voluntary."), *In re Technical Knockout Graph-*

ics, Inc., 833 F.2d at 801, ("The issue here is whether payment of taxes after the debtor has filed a petition for reorganization under Chapter 11, but prior to confirmation of the reorganization plan, is voluntary.").

That the common law rule is alive outside the context of taxation is evident from its modern application, for example, by a Federal district court's application of non-tax payments previously made under bankruptcy court order. *First Nat. City Bank v. Kline*, 439 F.Supp. 726 (S.D.N.Y. 1977). There, a bank sought payment from a guarantor of one of several debts owed to it by a bankrupt debtor. Pursuant to the bankruptcy (apparently a liquidation), an undesignated part payment had been made to the bank. In the action on the guaranty, one of the guarantor's defenses was that the part payment received by the bank should have been applied to the guaranteed debt. The bank, in a position analogous to that of the IRS here, took an opposite position. The court held that "[w]here, as here, moneys are repaid under judicial order, the court has exclusive authority to apply the funds, and its application must be structured as "equity and justice require." *Id.* at 729, citing *Bank of California v. Webb*, 94 N.Y. at 472 and *Orleans County Nat. Bank v. Moore*, 112 N.Y. at 548, 20 N.E. at 359. The court went on to apply the payment *pro rata* among all the debts.

GLK directly challenged the application of the dichotomy applied by the IRS as an unjustified and unauthorized diversion from the historically applied common law principles. The Ninth Circuit, however, erroneously refused to consider GLK's arguments, holding that this Court's *Energy Resources* decision required prohibition of any allocation by GLK because it was not "necessary" to the success of the Plan. The wisdom of more than 100 years of common law stands to vanish without comment absent this Court's intervention via certiorari.

c. Upon commencement of its Chapter 11 proceeding, an estate was created comprised of all GLK's property and rights therein. 11 U.S.C. §541. The Bankruptcy Court acquired jurisdiction over all such property. 28 U.S.C. § 151 and §1334(d). As debtor in possession, GLK reacquired or retained all rights and interests in its property, subject to its duties as provided by law, its plan of reorganization, and to the court's jurisdiction. 11 U.S.C. §1107(a). Nothing in the Bankruptcy Code eliminated GLK's common law right, as a debtor, to apply its payments.[5]

The Court of Appeals' requirement that a designation provision be stricken unless "necessary" to the success of a reorganization plan abolishes the otherwise available right of a debtor to designate how its payments are to be applied. The issue was raised by petitioner GLK; however, the Ninth Circuit refused to consider the argument, relying solely on this Court's opinion in *Energy Resources*. Thus, important rights of GLK and other debtors will continue denied unless this Court grants review and the Ninth Circuit's erroneous interpretation of the Court's Opinion in *Energy Resources* is corrected.

3. The law requires that any proposed plan of reorganization meet certain requirements and make certain provisions. 11 U.S.C. §1123. GLK's Plan met those requirements. A plan may, however, also contain "any other appropriate provision not inconsistent with the applicable provisions of [Title 11]." 11 U.S.C. §1123(b)(5). If a debtor's plan meets the requirements of the law, the Court is required to confirm it. 11 U.S.C.

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[5] Petitioner GLK recognizes that the bankruptcy court may, where appropriate, modify debtor rights. Here, however, the Ninth Circuit decision has inverted the law by effectively permitting the IRS to unilaterally deny debtors' allocation rights absent a showing of "necessity."

§1129(a) and (b)(1). Thus, the Court is given specific authority to review and confirm plans with provisions designating how payments to creditors should be applied unless such provisions conflict with other provisions of the Bankruptcy Code. The Government's arguments to the effect that Section 6672 of the Internal Revenue Code (26 U.S.C.) reflects a congressional intent to permit the IRS to override a debtor's common law rights with the implementation of its policy were rejected in *Energy Resources*. *See*, *Energy Resources*, 110 S.Ct. at 2142. A requirement that a designation provision must be found "necessary" to the success of a reorganization plan adds an undue and inappropriate restriction on and impediment to reorganization plans and the inclusion of "other appropriate provisions" under Bankruptcy Code Section 1123(b)(5). Under 11 U.S.C. § 1123(b)(5), a finding of "necessity" is not required; only the absence of any conflict with other provisions of the Bankruptcy Code is mandated. GLK's allocation provision was consistent with its longstanding common law right to designate application of its payments; and it was "not inconsistent" with the Bankruptcy Code. The bankruptcy court's striking was affirmed by the Ninth Circuit based solely on an erroneous interpretation of this Court's holding in *Energy Resources*. It clearly conflicts with unambiguous statutory language. This Court should hear this case to settle and resolve this important and now confused question of Federal law.

4. The Bankruptcy Code also authorizes the bankruptcy court to issue any order "necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." 11 U.S.C. § 105. Requiring a finding that an allocation provision be "necessary" adds a substantive requirement which is neither expressed nor implied by Bankruptcy Code § 105 and which is in conflict with Bankruptcy Code § 1123. Where, as here, the I.R.S. has publicly an-

nounced and maintains a policy that deprives debtors of their common law rights without statutory authorization to implement such policy, it is necessary and appropriate that the bankruptcy court issue an order which permits, or otherwise approves, the exercise of that right. It was just such an order which GLK sought and was denied.

CONCLUSION

The decision of the Ninth Circuit Court of Appeals in this case conflicts with this Court's Opinion in *Energy Resources*, conflicts with debtor rights recognized by this Court for more than 100 years, and conflicts with the Bankruptcy Code itself. Since the Ninth Circuit purports to rely on this Court's *Energy Resources* opinion for its holding, only this Court can answer the important questions of Federal law presented. Therefore, this petition for writ of certiorari should be granted.

Respectfully submitted,

MARK BERNSLEY
Counsel for GLK, Inc.

MARCH, 1991

APPENDIX A

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 89-55196

In re GLK, Inc., Debtor

GLK, Inc., dba MGAS; Marvin Givant
Attorney Service; Spirit Legal Courier
Messenger Service, Appellant,

v.

United States of America, on behalf
of Internal Revenue Service, Appellee.

Appeal from the Ninth Circuit
Bankruptcy Appellate Panel
Volinn, Meyers and Jones, Judges, Presiding

Filed December 28, 1990

PER CURIAM:

The debtor, appellant GLK, Inc., filed a proposed plan of reorganization pursuant to Chapter 11 of the Bankruptcy Code. The plan contained a provision that payments by GLK to the Internal Revenue Service would be "applied first to any trust fund liability." The bankruptcy court found that these tax payments were involuntary, and for that reason it entered an order striking the allocation language from the plan. In doing so the bankruptcy court relied on *United States v. Technical Knockout Graphics, Inc. (In re Technical Knockout Graphics, Inc.)*, 833 F.2d 797 (9th Cir. 1987). GLK appealed the bankruptcy court's order to the bankruptcy appellate panel ("BAP"). The BAP affirmed, and GLK then appealed to this court.

During the pendency of this appeal, the Supreme Court decided *United States v. Energy Resources Co.*, 110 S. Ct. 2139 (1990). The Court held that bankruptcy courts "may order the IRS to apply tax payments to offset trust fund obligations where it concludes that this action is necessary for a reorganization's success." *Id.* at 2143.

We remanded this case to the BAP for remand to the bankruptcy court to make a finding on whether allocation of GLK's tax payments to the trust fund tax liability was necessary to the success of the plan of reorganization. The bankruptcy court found that such an allocation was not necessary to the success of the plan. Thus, regardless of whether the payments are classified as "voluntary" or "involuntary" the bankruptcy court did not err in striking the allocation language from the plan.

The decision of the bankruptcy appellate panel is AFFIRMED.

APPENDIX B

APPENDIX B

UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA

Bankruptcy Case No. LA 85-05681 GM (Chapter 11)

In re

GLK, INC., a California corporation
d/b/a MGAS; d/b/a MARVIN GIVANT
ATTORNEY SERVICE; d/b/a SPIRIT LEGAL COURIER
MESSENGER SERVICE, Appellant,

ORDER RE PAYMENTS BY DEBTOR
TO INTERNAL REVENUE SERVICE
UNDER PLAN OF REORGANIZATION

Filed August 9, 1990

Entered August 14, 1990

This matter is before this court on remand from the Bankruptcy Appellate Panel (BAP No. CC-88-1174), pursuant to Order from United States Court of Appeals for the Ninth Circuit filed June 20, 1990, (No. 89-55196), for the purpose of making specific findings on whether it is necessary to the success of the debtor's Plan of Reorganization (the "Plan") that payments to the Internal

Revenue Service under the Plan be allocated first to payment of the "trust fund" portion of taxes owed. *See, United States v. Energy Resources Co., Inc.*, ___ U.S. ___, 110 S.Ct. 2139, 109 L.Ed.2d 580 (1990).

Mark Bernsley, Esq., appeared for the debtor. Edward M. Robbins, Jr., Assistant United States Attorney, appeared for the United States of America.

Upon consideration of the papers submitted by the parties, oral argument of counsel, and the entire record in this case, good cause appearing therefor, the Court finds that, under the circumstances of this case, the designation in the Plan that tax payments to the IRS be applied first to any "trust fund" liability, is not necessary to the success of the Plan.

The debtor submitted a proposed plan of reorganization that included the following provision with respect to the pre-petition employment taxes:

> "Claims in Class IV shall be paid at the rate of $6,000, or more, per month to be applied first to any trust fund liability, for a period of five years after the effective date of the Plan, at which time all remaining principal and interest shall be paid in full. * * * "

The United States objected to the portion of the above-quoted language which designated how the payments were to be applied, arguing that due to the "involuntary" nature of the payments, the debtor was not entitled to designate how they were to be applied.

On September 16, 1987, this Court confirmed the Plan, but ordered that the designation issue would be determined at a later hearing.

At hearing on December 22, 1987, this Court held that, under the holding of the Ninth Circuit Court of Appeals in *In re Technical Knockout Graphics*, 833 F.2d 797 (9th Cir. 1987), the payments to the Internal Revenue Service under the Plan were "involuntary" and could not be allocated by the debtor. By Order entered Febru-

ary 23, 1988, the allocation language in the Plan was ordered stricken, and the Internal Revenue Service was permitted to apply debtor's payments "as the Internal Revenue Service deems appropriate."

The debtor appealed.

The Court is uncertain as to whether the findings to be made on this remand are to be made as of the time of confirmation of the Plan or as of now. Under the circumstances of this case, the findings would be the same and this Court makes both findings.

At the time of the confirmation, this Court had before it a declaration of Joseph Karotkin, a shareholder and officer of the debtor, which this Court accepts as true for the purpose of these findings. In short, the Court understands from the declaration that upon a liquidation, the debtor would have sufficient assets to satisfy all secured claims and priority creditors through 11 U.S.C. § 501(a)(7), the level of the Internal Revenue Service employment tax claims. Debtor's officers maintain that their ability to devote their energies to the debtor's business would be compromised by potential Internal Revenue Service's enforced collection action of their individual liability for the "trust fund" portion of the taxes under 26 U.S.C. § 6672; and, that if no designation could be made, the officers and shareholders would chose to liquidate debtor GLK to satisfy such tax obligations rather than face the emotional and financial trauma of such collection action. Thus, debtor maintains that the designation in the Plan was necessary to the success of its Plan.

The Internal Revenue Service stated at the hearing that, in light of the law explained in *Energy Resources*, *supra*, it would have stipulated to a stay of collection of the employment taxes from debtor's responsible officers, so long as those officers agreed to appropriate extensions of the statute of limitations on collection, and so long as

the debtor made the tax payments required under the Plan.

During the appeals, the debtor and the Internal Revenue Service reached an informal agreement that the Internal Revenue Service would suspend enforced collection activity against debtor's officers upon whom liability is imposed under 26 U.S.C. § 6672, during the appeal process. Those responsible officers have agreed to extensions of the statute of limitations with respect to collection of that liability.

This Court also notes the additional fact that the debtor is now almost three years into its confirmed Plan. Presumably the Plan is succeeding.

The parties have entered into a stipulation filed with this Court pursuant to which the Internal Revenue Service has agreed that, so long as there remains sufficient time under the applicable statute of limitations on collection of any liability under 26 U.S.C. § 6672, no action will be taken to collect that liability so long as the debtor makes the tax payments to the Internal Revenue Service required under the Plan.

The Court finds that whether considered as of the time of confirmation of the Plan or currently, the result is the same. The concerns of the debtor are adequately addressed by the Internal Revenue Service stipulation not to enforce collection against debtor's responsible officers. If the responsible officers were or became unwilling to cooperate in allowing the Internal Revenue Service a reasonable period in which to collect their liability under 26 U.S.C. § 6672 in the event the debtor defaulted in its obligation under the Plan, this Court would strike the allocation provision as not presented in good faith or consistent with its fiduciary duty to protect its creditors. Thus, this Court concludes that the designated allocation language is not necessary to the success of the debtor's Plan.

It is so ordered.

DATED: August 9, 1990

/s/ Geraldine Mund
Hon. Geraldine Mund,
U.S. Bankruptcy Judge

APPENDIX C

APPENDIX C

UNITED STATES
BANKRUPTCY APPELLATE PANELS
OF THE NINTH CIRCUIT

BAP No. CC-88-1174 VMeJ
Bk No. LA 85-05681 GM

In re GLK, Inc., Debtor

GLK, INC., a California corporation,
d/b/a MGAS; d/b/a MARVIN GIVANT
ATTORNEY SERVICE; d/b/a SPIRIT LEGAL COURIER
MESSENGER SERVICE, Appellant,

v.

UNITED STATES OF AMERICA, on behalf
of INTERNAL REVENUE SERVICE, Appellee.

Appeal from the United States Bankruptcy Court
for the Central District of California
Hon. William J. Lasarow and Hon. Geraldine Mund,
Bankruptcy Judges, Presiding

Filed December 28, 1990

Before: VOLINN, MEYERS and JONES,
Bankruptcy Judges

MEMORANDUM

VOLINN, Bankruptcy Judge:

I. OVERVIEW

Debtor GLK, Inc. (GLK) appeals a decision that it may not designate in its plan that the Internal Revenue Service (IRS) allocate payments on tax claims first to trust fund taxes. Whether or not payments made under a plan of reorganization to the United States for unpaid prepetition federal tax liabilities are involuntary and may be allocated at the discretion of the IRS was decided in favor of the IRS by this court in *United States v. Condel (In re Condel)*, 91 B.R. 79 (9th Cir. BAP 1988). Accordingly, we affirm the order below.

II. FACTUAL AND PROCEDURAL BACKGROUND

GLK filed for relief under Chapter 11 on April 26, 1987. On September 16, 1987, its reorganization plan was confirmed.

However, due to objections by the appellee, United States of America (U.S.A.), and the pending resolution by the Ninth Circuit of a similar issue, decision was delayed on GLK's challenged attempt to compel the IRS to allocate tax payments under the plan first to trust fund tax liabilities. Upon filing, GLK owed the United States $309,460.61 in unpaid F.I.C.A. Withholding and F.U.T.A. taxes. "Trust fund taxes" refers to income and social security taxes that an employer is required to withhold from the wages and salaries paid to its employees and hold in trust for the federal government. 26 U.S.C. §

7501. Congress has imposed liability for payment not only on the employer, but also on any person who "wilfully fails to collect, truthfully account for and pay over [such] tax . . . ." 26 U.S.C. § 6672(a). The liability is imposed on responsible persons as a penalty equal to "the total amount of the tax evaded, or not collected . . ." by the employer. *Id.*

After the Ninth Circuit's decision was issued, the court below decided that it was compelled to enter a finding in favor of the IRS. The order appealed struck the language in the plan that directed the IRS to apply payments first to trust fund taxes.

III. ISSUE

Are payments to the government under a Chapter 11 plan voluntary so that the debtor has the discretion to specify, contrary to IRS intentions and policy, that payments on tax claims be allocated first to claims for trust fund taxes?

IV. STANDARD OF REVIEW

We review conclusions of law *de novo*. *United States v. Camino Real Landscape Maintenance Contractors, Inc. (In re Camino Real Landscape Maintenance Contractors, Inc.)*, 818 F.2d 1503, 1505 (9th Cir. 1987); *Crocker Nat'l Bank v. American Mariner Indus., Inc. (In re American Mariner Indus., Inc.)*, 734 F.2d 426, 429 (9th Cir. 1984). No factual dispute is presented.

V. DISCUSSION

This court considered the identical issue in *United States v. Condel, Inc. (In re Condel)*, 91 B.R. 79 (9th Cir. BAP 1988). The panel held that the question is controlled by *United States v. Technical Knockout Graphics, Inc. (In re Technical Knockout Graphics, Inc.)*, 833 F.2d 797 (9th Cir. 1987) and reversed an order that confirmed a plan, providing "[f]or each dollar of taxes, interest and

penalties paid, any corresponding penalty assessment shall be reduced by one dollar." *Condel*, 91 B.R. at 80, 82. In the Ninth Circuit case, the court concluded that tax payments after the filing of a Chapter 11 case, but before filing a plan, are involuntary and the IRS, therefore, may apply the payments as it sees fit. 833 F.2d at 803.

GLK argues here, as did the debtor in *Condel*, that the opinion in *Technical Knockout Graphics* is distinguishable because it involved payments made before confirmation. However, as the panel indicated in *Condel*, this factual difference is not material and does not deter us from following the Ninth Circuit's reasoning and holding. As the Ninth Circuit discussed, the discretion of a Chapter 11 debtor is constrained by its duties under the Code and the oversight functions of the court with reference to the administration of the case and payment of prepetition liabilities. Confirmation of the plan does not materially affect the debtor's circumstances for purposes of classifying tax payments as voluntary or involuntary in light of Code limitations on plans and the court's authority to ensure that plans comply with the Code, 11 U.S.C. §§ 1123, 1129, as well as reorganized debtors' obligations to comply with their plans. 11 U.S.C. 1142.

VI. CONCLUSION AND ORDER

For the foregoing reasons, we conclude that the plan payments to the IRS are involuntary. We AFFIRM the order below that disapproved language in the plan, compelling the IRS to allocate plan payments, as the debtor directed, first to trust fund taxes.

APPENDIX D

APPENDIX D

UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA

Bankruptcy Case No. LA 85-05681 GM (Chapter 11)

In re

GLK, INC., a California corporation
d/b/a MGAS; d/b/a MARVIN GIVANT
ATTORNEY SERVICE; d/b/a SPIRIT LEGAL COURIER
MESSENGER SERVICE, Appellant,

ORDER RE PAYMENTS BY DEBTOR
TO INTERNAL REVENUE SERVICE
UNDER PLAN OF REORGANIZATION

Filed February 19, 1988

A hearing on the issue of whether the debtor in this case may designate that the payments under its plan of reorganization to the Internal Revenue Service on account of its priority and secured claims be applied first to the "trust fund" portion of the taxes owed came before the Court, the Honorable Geraldine Mund presiding, on December 22, 1987 at 9:00 a.m. Appearing for the debtor were Dean Sperling of the Law Offices of David Bloom and Mark Bernsley. Appearing for the United States of America, Internal Revenue Service was A. Lavar Taylor, Assistant United States Attorney. The Court having reviewed all submissions of the parties and having

reviewed the opinion of the Ninth Circuit in *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987), is of the view that the payments by the debtor under its plan of reorganization to the Internal Revenue Service are involuntary in nature. Accordingly,

IT IS ORDERED that the language in the debtor's plan of reorganization directing that payments to the Internal Revenue Service shall be applied first to the "trust fund" portion of the taxes owed is STRICKEN.

IT IS FURTHER ORDERED that the Internal Revenue Service may apply the payments to the Internal Revenue Service under the debtor's plan of reorganization as the Internal Revenue Service deems appropriate.

DATED: Feb. 19, 1988

/s/ WILLIAM J. LASAROW
UNITED STATES BANKRUPTCY JUDGE